Securities Industry

Trends

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

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DISCOUNTERS' DOLDRUMS

The number thirteen has turned out to be very unlucky for the discount brokerage business. It has been that many years since "May Day," when mandatory fixed-rate commissions were abolished, and discounters, as well as other brokerages relying on the retail customer, are now struggling in an anemic environment. Although discounters' P&Ls are still in the black, they are using a lot less ink to pen their bottom line.

Highlights

1. Discounters' pre-tax returns on equity, once the best in the industry, fell from 50% in 1986 to 20% last year to a razor thin 6% in this year's first quarter.

2. After a decade of rising market share in industry commissions, revenues, profits and retail commissions, the discounters' slice of these pies shrank in the first quarter, and that's out of much smaller pies to begin with.

3. Although last October's huge equity volumes helped boost discounters' commissions and revenues, their quarterly losses on bad debts and errors jumped from a normal $1-$2 million to over $60 million, causing a probable $20 million profit to become a $40 million-plus loss.

4. The outlook for retail commissions, a full three-fifths of discounters' total revenues, has worsened as the year progressed. New York Stock Exchange retail "activity" (both sales and buys) peaked with October's 183 million shares per day but crashed to only 86 million per day in the first quarter. Worse, still, it cascaded further to only 80 million per day in May!

5. Business concentration among the discounters continues. The 26 NYSE discounters, including all the large national discounters, captured 85% of all discounters' commissions and revenues last year and 90% of all discounters' profits; these concentration ratios set new records.

INTRODUCTION

This issue of Trends is an update of two prior issues dealing exclusively with discount brokers: Trends, March 4, 1983, "A Primer on Discount Brokers" and June 26, 1987, "Discounters' Dozen Years." These prior issues, moreover, were meant to fill the void on discount brokers which was created when the U.S. Securities and Exchange Commission (SEC) discontinued its analysis of this segment of the securities industry. The last SEC study analyzing discounters was their Staff Report on the Securities Industry in 1980.

In order to avoid repetition, and undue lengthy reporting, this issue of Trends does not again review the advent and history of discounters nor our previous critiques and analysis of the various universes of discounters and methodologies used by the SEC and the SIA in the Seventies and early Eighties. For those interested in a more complete history of discounters, much of this can be found in last year's "Discounters' Dozen Years" or the previously cited reports on discounters.

This issue concentrates on recent performance and market share of "pure" discount broker-dealers (those broker-dealers identified as mainly engaged in the agency equity commission business and holding themselves out as discounters) and their clearing businesses.

Issues of Trends which analyze the profitability of the securities industry and different firm categories utilize a universe of New York Stock Exchange (NYSE) member firms which deal with the public based on data from their quarterly FOCUS

Reports submitted to the Exchange. These categories, known as SEC/SIA firm categories, are familiar to the long-term Trends reader. Examples are National Full Line firms, Large Investment Banks, Regional firms, etc.

The Discounter group, as with other categories, deals with those discounters which are members of the NYSE. However, NYSE Discounters are relatively few in number (currently 26) although they have accounted for the majority of discounters' business in recent years (see Table 2). Also, the "total industry" in other issues of Trends also deals only with NYSE members which deal with the public (around 400 firms accounting for around 80% of all broker-dealers' revenues and 85% of their assets).

For this (and prior) analysis of discounters, we expand the universe of discounters and total industry beyond NYSE firms and include members of the National Association of Securities Dealers (NASD) in these two universes (exclusive of double counting).

In some cases, such as in Table 7, we refer to just the NYSE discounters and all NYSE firms as discounters and "total" industry, to allow us to analyze this year's first quarter (because NASD data is still not available). There is a much longer lag time in obtaining FOCUS data about the sole NASD members (one reason we use just NYSE firms in our other analysis). When using either of the two universes, however, they are clearly indicated and the reader should be aware of this distinction.

DISCOUNT BROKERS -- BOOM TO BANE

There is no group of securities firms more dependent on commission revenues and the retail investor than the discount broker. This focus and dependence was a boon to these firms during the bull market's unprecedented investing fervor but has become a bane in the post-October world.

Retail investors, the lifeblood of many securities firms including the discounter, closed up shop after last October's market break. For example, commissions, discounters' bread and butter revenue source, fell 27% in the first quarter of this year from the same period a year earlier. Moreover, the $2.4 billion in commissions that New York Stock Exchange member firms did manage to eke out in the anemic environment of 1988's first quarter was the poorest quarterly showing since 1985!

In the immediate aftermath of October's crash, 1987's fourth quarter, the securities industry suffered its largest quarterly loss ever -- over $2 billion in red ink before taxes, 22 times the previous record quarterly loss. As a group, the NYSE and NASD discounters also showed a loss in the fourth quarter of last year, $42 million. However, this was not due to a quarterly drop in commissions or revenues. In fact, boosted by October's huge transaction volume, the fourth quarter was actually the best in terms of commissions for the discounters, $224 million (Table 1), and revenues of $360 million were about even with the preceding three quarters.

Table 1

1987 QUARTERLY PERFORMANCE OF NYSE/NASD FIRMS

(In Millions of Dollars)

Discounters

	Q1	Q2	Q3	Q4
Commissions	212.3	207.4	207.3	223.7
Revenues	363.3	364.4	362.7	359.8
Pre-Tax Profits	66.1	53.7	40.2	(42.0)
Equity Capital	595.8	677.4	711.6	664.9

All Firms

Commissions	4,125.7	3,816.8	3,959.3	4,032.8
Revenues	17,994.1	15,708.5	16,442.3	13,206.9
Pre-Tax Profits	2,587.6	761.6	910.4	(2,343.1)
Equity Capital	30,310.7	31,140.8	32,374.5	32,717.8

Losses in error accounts and bad debts skyrocketed for the securities industry in October. DKs and unmet margin calls plagued the industry that month, although given the unprecedented 600 million share days on the Big Board and the biggest market crash ever, things actually ran rather smoothly. Discounters, as a group, saw this loss error expense line jump from an average $1-$2 million per quarter to over $60 million in the fourth quarter. That explosion turned a potential $20 million profit into a $42 million loss. A good portion of this loss is probably attributable to one well-publicized loss in a single account at one discounter.

According to another SIA Research publication, the Investor Activity Report (IAR), the average daily **"retail"** activity on the Big Board,[1] both purchases and sales, hit a record 183 million shares per day in October ("share activity," by counting both sides of a transaction, buy/sell, is generally double the reported "volume" activity reported by exchanges). One month later, November's retail activity was down to 128 million shares daily. The sluggish activity, particularly retail, so far in 1988 does not bode well for the discounters. According to the IAR, estimated NYSE retail activity fell to 86 million shares daily in the first quarter and continued to slide down to a mere 80 million shares daily by May! Also, this slowdown was even more evident on other marts including the AMEX and NASDAQ.

What has this done to the discounters' P&L so far this year? Unfortunately, as mentioned, first quarter results for all discounters are still not available. However, we can look at the group of discounters which are NYSE members. Although this group contains just over two dozen firms, it incorporates all the large national discounters and the group as a whole accounts for most of the discounting business as shown in Table 2.

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1 Retail activity is derived by taking total purchases and sales on the New York Stock Exchange (NYSE) and then subtracting all institutional sales and purchases reported through the Depository Trust Co.'s Institutional Delivery System and all NYSE member trading reported to the NYSE on Form 121. The remaining share activity, after estimated adjustments for dividend recapture programs and corporate stock repurchase programs, is considered "retail."

Table 2

NYSE DISCOUNTERS' SHARE OF ALL DISCOUNTERS

(In Percent)

	1986	1987
Commissions	82.4	84.3
Revenues	81.5	84.8
Expenses	80.7	84.4
Pre-Tax Profits	86.0	89.4

As Table 3 clearly shows, NYSE Discounters' business in the first quarter of 1988 has fallen back to 1986 levels in both commissions and total revenues. However, their expenses have not been pared back to 1986 levels, although they have been pared back quite a bit since October. Profits are about one-third their 1986 levels while their pre-tax profit margin has been slashed to a meager 4%.

Table 3

NYSE DISCOUNTERS QUARTERLY PERFORMANCE

(In Millions of Dollars)

	86:Q1	86:Q2	86:Q3	86:Q4	87:Q1	87:Q2	87:Q3	87:Q4	88:Q1
Commissions	134	138	134	134	177	174	175	191	133
Revenues	222	227	214	231	303	308	311	308	255
Profits	44	38	31	28	57	49	39	(39)	10
Profit Margin	20%	17%	14%	12%	19%	16%	13%	(13%)	4%

Of course, the discounters are not the only firms who have suffered since October. Other categories of NYSE firms who also depend a great deal on the retail customer are the National Full Line and Regional firms. Table 4 shows how the NYSE Discounters and these two groups (as well as all NYSE firms) have fared

in profitability during the Eighties. In most years, the discounters' profit margins and ROE have been the best of all these groups. However, so far this year, the discounters have lagged the NYSE group as well as the Regional firms and performed only slightly better than the National Full Line group which historically has operated on the thinnest margins of any category of firms.

Table 4

PRE-TAX PROFIT MARGINS

(In Percent)

NYSE Firm Category	80	81	82	83	84	85	86	87	88:Q1
National Full Line	10.9	6.9	8.8	8.6	(0.9)	5.6	6.9	(0.9)	1.4
Regionals	14.7	11.2	11.1	12.6	2.6	9.4	11.0	5.5	4.3
All NYSE Firms	14.1	10.8	13.1	12.9	5.2	10.7	11.0	2.3	8.7
NYSE Discounters	**17.5**	**12.2**	**13.6**	**14.0**	**0.3**	**8.9**	**15.7**	**8.6**	**3.8**

PRE-TAX RETURN ON EQUITY

(In Percent)

NYSE Firm Category	80	81	82	83	84	85	86	87	88:Q1
National Full Line	45.0	24.6	29.8	28.1	(2.6)	17.9	20.3	(2.1)	2.9
Regionals	N.A	37.2	36.0	40.5	6.8	29.0	32.7	14.1	9.2
All NYSE Firms	49.2	35.9	40.5	36.6	13.3	29.4	28.6	4.9	18.1
NYSE Discounters	**N.A**	**52.2**	**53.9**	**46.7**	**0.8**	**25.6**	**49.5**	**19.7**	**6.4**

Also, after several years of waning profitability in the early Eighties, the discounters appeared to be making a strong comeback by 1986, but last year's events put an abrupt halt to this progress.

DISCOUNTERS' MARKET SHARE

The most often asked question regarding discounters seems to be: "What is their market share?" For about a decade, there seems to have been a never-changing number bandied about in the financial press, at conferences, etc., which is the "never-sourced" answer to this question -- 20%!

This may be an attempt to define market share as the share of retail transactions, but it is not proven and in any case wouldn't have remained constant!

However, since we know of no way to track retail transactions, we will, as in the past, measure discounters' market share in terms of their share of monies generated: revenues, profits, commissions and estimated retail commissions. Tables 5 and 6 show the results of all discounters vs all firms for the past five years (both NYSE and NASD broker-dealers) and the discounters' market share. Two assumptions are made in determining discounters' market share of retail commissions. The first, based on informal surveys of SIA member firms, is that two-thirds of the industry's commissions are from retail activity. The second is that 100% of discounters' commissions are from retail activity, although the actual figure is probably somewhat lower.

The first striking fact is that discounters, despite a relatively poor 1987, continued to gain market share in commissions, retail commissions, revenues, and particularly profits. This matches what we've already seen--despite discounters' falling profitability in 1987, the total securities industry's declining profitability was so much more severe, that discounters' slice of the much smaller pie was relatively bigger.

Table 5

DISCOUNTERS

($ Millions)

	1983	1984	1985	1986	1987
Commissions	335.3	325.9	443.0	654.5	850.7
Revenues	529.9	595.1	770.0	1,096.8	1,450.2
Expenses	467.6	589.1	701.3	933.5	1,332.2
Pre-Tax Profits	62.3	6.0	68.7	163.3	118.0
Return on Equity	35.8%	2.7%	26.2%	45.6%	19.3%
(% Share of Total Industry)					
Commissions	3.4	3.7	4.2	4.9	5.3
Revenues	1.5	1.6	1.6	1.8	2.3
Pre-Tax Profits	1.4	0.3	1.3	2.3	6.2
Estimated Retail Commissions*	5.1	5.6	6.4	7.3	8.0
No. of Firms	106	120	117	122	122

*Retail commissions for the total industry are estimated to be two-thirds of total commissions while all discounters' commissions are considered retail.

Table 6

TOTAL INDUSTRY

($ Millions)

	1983	1984	1985	1986	1987
Commissions	9,840.4	8,763.3	10,432.9	13,430.1	15,934.6
Revenues	34,336.4	37,048.0	46,844.3	61,017.7	63,351.8
Expenses	29,810.7	34,908.5	41,459.2	53,905.5	61,435.3
Pre-Tax Profits	4,525.7	2,139.6	5,385.1	7,112.2	1,916.5
Return on Equity	34.6%	14.0%	29.8%	28.8%	6.2%
No. of Firms	4,027	4,867	5,714	6,387	6,331

But what about the tough year we are now in? Have discounters managed to keep their market share of this year's small pie? As previously noted, all discounter data is not yet available. But if we take the NYSE Discounters' share of all discounters' financials for the past two years (as in Table 3) and project it onto what the NYSE Discounters reported in the first quarter, discounters lost some market share in 1988's first quarter, particularly in profits (Table 7).

Table 7

DISCOUNTERS' MARKET SHARE

(In Percent)

NYSE Discounters' Share of NYSE Firms

	86	87	88:Q1
Commissions	5.1	5.7	5.5
Revenues	1.8	2.4	2.0
Pre-Tax Profits	2.5	9.0	0.9
Estimated Retail Commissions*	7.7	8.5	8.2

NYSE NASD Discounters' Share of All NYSE/NASD Firms

	86	87	88:Q1*
Commissions	4.9	5.3	5.2
Revenues	1.8	2.3	2.0
Pre-Tax Profits	2.3	6.2	0.1
Estimated Retail Commissions*	7.3	8.0	7.8

*Estimated based on 1986-87 NYSE vs NYSE/NASD market shares.

These estimated drops in market share for all discounters from 5.3% to 5.2% - of commissions, 2.3% to 2.0% in revenues and 8.0% to 7.8% in retail commissions

do not look too drastic for 1988's poor environment (although their drop in share of profits was severe). One should remember, however, that these slightly lower market shares are percentages of a much, much smaller retail revenue base this year!

THE EARLY YEARS

As mentioned, the SEC began tracking discounters as a group in the Seventies. Although some securities firms engaged in the practice of discount commissions for certain types of allowable transactions prior to May 1, 1975, that date, "May Day," marked the end of all mandatory, fixed-rate commissions for the securities industry, and thus the dawn of discounters.

The SEC identified 70 firms it considered discounters in 1975 which grew to 82 the following year. For the years 1977 through 1980, the SEC, in its Staff Report on the Securities Industry in 1980, compared an identified universe of discounters to the total securities industry in terms of commissions and total commissions (Table 8). Since the SEC discontinued tracking this group of firms for subsequent years, SIA followed the SEC's basic analysis for the following two years. Table 8 combines the two analyses which shows that both the number of discounters and their market expanded each year. Although this analysis cannot be directly compared to our previous analysis of discounters for years after 1982 (the universe of discounters after 1982 was adjusted by eliminating firms which were not considered "pure" discounters), both analyses show that discounters continued to expand in both number and market share year after year, through 1987.

Table 8

DISCOUNTERS' EARLY GROWTH*

(Dollar Amounts in Millions)

	1977	1978	1979	1980	1981	1982
Industry Commissions	$3,035	$4,036	$4,512	$6,377	$6,143	$6,454
Discounters' Commissions	$70	$103	$137	$241	$251	$314
Discounters' Share	2.3%	2.5%	3.0%	3.8%	4.1%	4.9%
Estimated Industry Retail Commissions	$1,982	$2,736	$3,023	$4,234	$3,987	$3,743
Discounters' Market Share of Retail Commissions	3.5%	3.8%	4.5%	5.7%	6.3%	8.4%
Number of Discounters	90	99	114	125	131	136

*The universe of discounters analyzed here differs from those analyzed in subsequent years and thus is not directly comparable to analysis of discounters for years 1983 and beyond.

Source: U.S. Securities and Exchange Commissions' "Staff Report on the Securities Industry in 1980" (for years 1977-1980); Securities Industry Association (1981 and 1982).

Based on our previous discussion of the NYSE Discounters' performance in this year's first quarter, it would appear that the post-October market environment has halted, at least temporarily, this expansion. However, 1988 is far from over and the true answer will be visited again in a future Trends issue. Frankly, not only discounters, but the entire securities industry anxiously awaits the return of the individual investor.

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VOLUME

	APR 1988	YTD 1988	APR 1987	YTD 1987	% CHAN Q1 1988-1987
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	163.0	174.7	187.1	186.0	-6.1%
AMEX (MILS.)*	10.5	10.7	14.4	15.0	-28.5%
NASDAQ (MILS.)*	125.1	127.7	144.3	151.9	-15.9%
REGIONAL EXCHANGE (MILS.)*	23.7	24.7	28.2	28.3	-13.0%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$111,280	$482,813	$172,672	$645,221	-25.2%
AMEX (MILS.)	2,671	11,103	4,369	19,519	-43.1%
ODD LOT SHARES PURCHASED ON NYSE (THOUS.)	7,774	30,326	13,140	47,144	-35.7%
ODD LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	14,826	59,609	19,575	77,050	-22.6%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	50.7%	51.6%	49.2%	50.7%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	9,282	36,412	18,715	70,175	-48.1%
AMEX OPTIONS	3,051	12,336	4,766	18,065	-30.5%
COMMODITY	17,786	76,364	23,203	71,866	6.3%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

PRICES
(END OF MONTH)

	APR 1988	APR 1987	% CHAN APR 1988-1987
DOW JONES INDUSTRIALS	1988.06	2032.33	-2.18%
STANDARD & POOR'S 500	258.89	261.33	-0.93%
NYSE COMPOSITE	146.60	147.87	-0.86%
AMEX MARKET VALUE INDEX	296.43	303.14	-2.21%
VALUE LINE COMPOSITE	228.14	229.79	-0.72%
NASDAQ COMPOSITE	374.64	379.24	-1.21%

YIELDS

(MONTHLY AVERAGES)

	APR 1988	APR 1987	BASIS POINT CHG 1988-1987
BOND BUYER INDEX (20 BOND)	7.81%	7.55%	26
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.67	8.85	82
Baa CORPORATE	10.90	10.04	86
RATIO Aaa CORPS. TO Baa CORPS.	0.89	0.88	1

	FIRST HALF 1988	FIRST HALF 1988	% CHANGE FIRST HALF 1987-1988
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$143,760.7	$158,220.7	-9.1%
Common Stock	$16,033.7	$25,591.6	-37.2%
# of Issues	196	512	-61.7%
Preferred Stock	$3,414.3	$6,983.2	-51.1%
# of Issues	61	96	-36.5%
Corporate Bonds	$124,312.8	$125,646.0	-1.1%
# of Issues	1,543	1,321	+16.8%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$38,195.9	$44,652.2	-14.5%
# of Issues	1,525	1,776	-14.1%
Competitive	$13,976.2	$13,281.3	+5.2%
# of Issues	1,604	1,821	-11.9%

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Wall Street's Workforce	The first ever comprehensive analysis of Wall Street's workforce based on a one-year study by SIA and Arthur Andersen. The 63-page book contains about 70 exhibits, and details headcount and productivity levels in the securities firms and the workforce itself. Example of the study's many findings: National Full Line firms generate 12.1 retail tickets daily for each retail producer, while clearing 13.6 retail tickets daily for each retail support person.	SIA Publications Dept. $150, SIA members; $250, others
Securities Industry Yearbook 1988-89	Ninth edition, 802-pages, containing detailed information on the over 550 securities firms that are members of SIA. Five part book includes rankings of firms by capital and number of offices, employees and salespersons; description of firms by type of business; geographic listing of firms; industry and market statistics; and SOURCES, the securities executive's guide to products and services.	SIA Yearbook Dept. $55, SIA members $90, others
"The Profitability of Insured Commercial Banks in 1987"	Annual article on commercial banks prepared by Federal Reserve Board of Governors. Huge provisions made by large banks for possible loan losses were the key to an unprecendented drop in the profitability of U.S. chartered insured commercial banks in 1987. The provisions, which were largely to cover troubled loans to developing countries, sharply reduced the industry's ROA and ratio of equity capital to assets. These provisions coupled with certain regional problems pushed more than 2,000 banks -- one-sixth of the total -- into the red in 1987. Article contains statistical measurements of profitability from 1983 to 1987.	Federal Reserve Bulletin July 1988
"First Half Financing Rankings"	Total first half 1988 underwritings came in at $143.8 billion, a 9% drop from the comparable period in 1987. Finishing on top overall as lead manager was Merrill Lynch, which captured 15.1% of all domestic corporate financing business. This is the first time Merrill has captured the number one spot in several years. Statistical data ranked by type of underwriting, including mortgage-backed and asset-backed securities.	Investment Dealers' Digest 7/11/88

Item	Description	Source
"Where have all the gurus gone?"	Stardom is out and marketing is in as Wall Street economists get down to the business of selling their firms. Brief review of Henry Kaufman's career at Salomon Brothers, followed by interviews with economists at several top firms discussing the parameters and demands of today's clients.	Institutional Investor July 1988
"Donkeys, Elephants, Bulls, Bears"	Are the Democrats or the Republicans better for the market? Short article with detailed graphics traces the Dow and economic statistics to present through Administrations starting with Truman. Conclusion: The Dukakis-Bush contest may decide who will be living at 1600 Pennsylvania Avenue, but its unlikely to provide much of a guide as to what's ahead for Wall Street or Main Street.	Barron's 7/25/88
The Impact of the Tax Reform Act of 1986 on the International Competitiveness of Service Industries	Three-part detailed examination, containing international tax survey and sectoral studies. Concludes: 1. Overall the 1986 Act has imposed a new obstacle to the competitiveness of the U.S. service sector exports and sales by foreign affiliates, and 2. The adverse effects are highly concentrated by sector, with banking, shipping, and insurance suffering large adverse effects.	Coalition of Service Industries, Inc. 2001 M. Street, N.W. Washington, D.C. 20036
"Treasury Defends Report on Capital Gains Taxes"	Authors of Treasury study, "The Direct Revenue Effects of Capital Gains Taxation," which found credence in the claim that lower capital gains taxes can produce additional revenue respond to Joseph Minarik's criticism of their methodology.	Tax Notes 7/25/88